

will give rise to valid claims for survivor benefits, such a high employment situation will tend to have counterbalancing effects such as that of inducing many of the widows and older children eligible for survivor benefits to forgo them by working.

No specific estimate of this type has been prepared for this report, but the demonstration from last year's report showing that the trust fund could weather an extremely severe, unlikely depression remains valid, and in fact the trust fund is in even a stronger position now.

APPENDIX V. THE STATUS OF THE SOCIAL SECURITY PROGRAM AND
RECOMMENDATIONS FOR ITS IMPROVEMENT—A REPORT OF THE
ADVISORY COUNCIL ON SOCIAL SECURITY

LETTER OF TRANSMITTAL

JANUARY 1, 1965.

THE BOARD OF TRUSTEES OF THE FEDERAL OLD-AGE AND SURVIVORS
INSURANCE AND DISABILITY INSURANCE TRUST FUNDS,
Washington, D.C.

GENTLEMEN: As required by section 116 of the Social Security Amendments of 1956 there is transmitted herewith the report of the Advisory Council on Social Security appointed in 1963. The report, as directed by law, includes the Council's findings and recommendations with respect to the financing of the old-age, survivors, and disability insurance program, and all other aspects of the program, including extensions of coverage and the adequacy of benefits.

Sincerely yours,

ROBERT M. BALL,
Chairman, Advisory Council on Social Security.

FOREWORD

As required by law, this Advisory Council was appointed by the Secretary of Health, Education, and Welfare in 1963. It is the second Advisory Council appointed under the Social Security Amendments of 1956. The first was appointed in 1957 and made its report on January 1, 1959. Under the law other advisory councils are to be appointed in 1966 and every fifth year thereafter.

Like the preceding Council and the councils to be appointed in the future, the present Council is required to review the status of the Federal Old-Age and Survivors Insurance Trust Fund and of the Federal Disability Insurance Trust Fund in relation to the long-term commitments of the social security program and to make a report of its findings and recommendations, including recommendations for changes in the social security tax rates. In addition, however, the law gives the present Council a special mandate; it provides that the Council "shall, in addition to the other findings and recommendations it is required to make, include in its report its findings and recommendations with respect to extensions of the coverage of the old-age, survivors, and disability insurance program, the adequacy of benefits under the program, and all other aspects of the program."

This Council, although only the second in the series established by the 1956 amendments, is the sixth major advisory group to consider social security in a long tradition of seeking advice and guidance from expert opinion and from those affected by the program. The first of these advisory groups played an important role in shaping the recommendations of the Executive Branch that led to the creation of the social security program in 1935. Additional groups appointed in 1938 and 1948 made broad studies of social security, and their recommendations played an important part in shaping the present program. A group appointed in 1953 dealt with extensions of coverage, and the one appointed in 1957 dealt only with financing.

The Council has studied the social security program for the last year and a half. It held its first meetings on June 10 and 11, 1963, and met frequently throughout the rest of 1963 and during 1964. Between meetings the Council continued its analysis of the program through a study of extensive materials. In addition, a subcommittee of three members, with the aid of two insurance company actuaries and one from organized labor as well as the actuarial staff of the Social Security Administration, has conducted a technical review of the practices followed in preparing the actuarial estimates for the program and reported its findings to the Council.

The Commissioner of Social Security, acting *ex officio* as Chairman of the Council in accordance with the provisions of law establishing the Council, has been presiding officer at the Council's meetings, and in other ways has helped to forward the work of the Council. As a government official, however, he has not taken a position on the recommendations of this essentially nongovernmental group.

The Council wishes to express its appreciation of the assistance of the staff of the Social Security Administration. The technical competence of the staff has been invaluable to the Council in conducting its review of the program

MEMBERSHIP OF THE COUNCIL

Robert M. Ball, Commissioner of Social Security, Chairman
 J. Douglas Brown, Dean of the Faculty, Princeton University
 Kenneth W. Clement, M.D., Practicing Physician and Immediate Past President,
 National Medical Association
 Nelson H. Cruikshank, Director, Department of Social Security, American
 Federation of Labor and Congress of Industrial Organizations
 James P. Dixon, M.D., President, Antioch College
 Loula F. Dunn, Director, American Public Welfare Association, 1949-1964
 Marion B. Folsom, Director and former Treasurer, Eastman Kodak Company
 Gordon M. Freeman, President, International Brotherhood of Electrical Workers
 Reinhard A. Hohaus, Director, Metropolitan Life Insurance Company, and
 Fellow, Society of Actuaries
 Arthur Larson, Director, Rule of Law Research Center, Duke University
 Herman M. Somers, Professor of Politics and Public Affairs, Princeton University
 John C. Virden, Chairman of the Board, Eaton Manufacturing Company
 Leonard Woodcock, Vice President, United Automobile, Aerospace and Agricultural Implement Workers of America

INTRODUCTION

A generation ago the United States established a system of contributory social insurance providing protection against the loss of earnings due to retirement in old age. Under this system employees, together with their employers, and self-employed persons make contributions during their working years and receive a continuing income for themselves and their families when they no longer have income from work.

As enacted in 1935 this social security program was limited to the risk of retirement in old age, and it was limited in coverage to industrial and commercial employees. Today, the program covers practically all kinds of employment and self-employment, and provides benefits for the wives and children of retired workers as well as for the retired worker himself. It provides benefits, also, for survivors of deceased workers and for totally disabled workers and their dependents when the disability is expected to be of long-continued and indefinite duration. Over the years the program has been improved and broadened in other ways as well. From time to time benefits have been increased, and other adjustments have been made, to take account of social and economic change and to improve the protection provided.

For the vast majority of Americans this Federal program of social security gives assurance that old age, total disability or death will not mean the end of a regular family income. Some 20 million men, women and children—1 out of 10 Americans—are receiving social security benefits every month. During 1964 about 77 million earners paid social security contributions. Nine out of ten children and their mothers can look to the program for a regular income if the head of the family should die. Over 85 percent of the people past 65 are either getting benefits or will be entitled to benefits when they or their husbands retire. About 53 million workers have now worked long enough in covered employment so that they and their families have disability insurance protection.

The Council strongly endorses the social insurance approach as the best way to provide, in a way that applies to all, that family income will continue when earnings stop or are greatly reduced because of retirement, total disability or death. It is a method of *preventing* destitution and poverty rather than relieving those conditions after they occur. And it is a method that operates through the individual efforts of the worker and his employer, and thus is in total harmony with general economic incentives to work and save. It can be made practically universal in application, and it is designed so as to work in ongoing partnership with voluntary insurance, individual savings, and private pension plans.

Under the social security program the right to benefits grows out of work; the individual earns protection as he earns his living, and, up to the maximum amount of earnings covered under the program, the more he earns the greater is his protection. Since, unlike relief or assistance, social security benefits are paid without regard to the beneficiary's savings and resources, people can and do build upon their basic social security protection and they are rewarded for their planning and thrift by a higher standard of living than the benefits alone can provide.

The fact that the program is contributory—that employees and self-employed workers make contributions in the form of earmarked social security taxes to help finance the benefits—protects the rights and dignity of the recipient and at the same time helps to guard the program against unwarranted liberalization. The covered worker can expect, because he has made social security contributions out of his earnings during his working lifetime, that social security benefits will be paid in the spirit of an earned right, without undue restrictions and in a manner which safeguards his freedom of action and his privacy. Moreover, the tie between benefits and contributions fosters responsibility in financial planning; the worker knows that improved benefits mean higher contributions. In social insurance the decision on how to finance improvements is always an integral part of the decision on whether they are to be made.

Because of these characteristics of social insurance the Council believes that where it can be properly applied it is much to be preferred to the method of public assistance, with its test of individual need, and the Council therefore strongly favors the improvement of social insurance as a way of reducing the need for assistance. The Council recognizes the need for an adequate public assistance program, but it believes that assistance should play the role of a secondary and supplemental program designed to meet special needs and circumstances which cannot be dealt with satisfactorily by other means.

No matter how well designed and administered, assistance has serious inherent disadvantages in terms of human dignity and incentives to work and save. People view receipt of assistance as meaning a loss of self-support. In contrast, they view social insurance as an extension of self-support. People who have led productive lives and have supported themselves through their own efforts do not want to see their self-reliance end with their ability to work.

Moreover, applying for assistance is at best a negative experience. Eligibility for assistance depends upon the individual's asking the community for help and proving that he is without the resources and income to support himself and his family. On the other hand, under social insurance the individual proves, not that he lacks something, but that he has worked and contributed, and has thus earned a right to a benefit.

In all its considerations a primary concern of the Council has been the financial soundness of the program. Clearly, no change in the program should be made, and no present trend should be permitted to continue, if the result were to jeopardize financial soundness in any way. In the light of this primary concern, the Council has undertaken to assure that the financing will be sufficient to meet all benefit and administrative costs as they fall due.

The Council has also considered the economic impact of the program. In important respects the program supports consumer demand and helps to prevent deflation. Because of social security, 20 million retired people, disabled people, widows and orphans now have an assured regular income which, of course, continues undiminished even when other segments of consumer income decline. Moreover, the program operates automatically to compensate in part for the loss of income arising from the higher rate of retirement that occurs when the general level of employment declines.

The Council is concerned, however, about the deflationary effect of the present contribution schedule in the years just ahead. Under that schedule there would be a shift from an approximate balance of income and outgo in 1965 to an annual rate of trust fund accumulation of about \$4 billion beginning in 1968. The Council recommends a large reduction in the size of these accumulations.

The Council is concerned also that in both the short run and the long run, the economic impact should be reasonable and should be capable of being absorbed by the economy and by the employee, employer and the self-employed without undue burden or strain. For this reason the Council is recommending that needed increases in both the contribution rate and the contribution and benefit base be put into effect gradually so that there will not be large changes in the level of contributions at any one time.

The Council's major recommendation in the pages that follow is for the extension of the program so that workers (and their employers) and the self-employed will make contributions during their working years in order to have protection against the cost of hospital care and related services in old age or in the event of permanent and total disability. The Council believes that the time has come to apply the method of social insurance to this pressing problem in order to assure the continuing effectiveness of retirement protection. While social security cash payments, if adequate, can assure that the older person and his family, or the disabled person and his family, will be able to meet regularly recurring, budgetable costs of food, clothing, and shelter, they cannot in practice be made sufficient to replace the need for insurance protection against the large and uncertain costs of hospital care. If our social insurance system is to be truly effective in preventing both dependency and the fear of dependency, the system must be broadened to include hospital insurance for the aged and the totally disabled. Otherwise more and more of these people will have to turn for help to public assistance—with all the disadvantages that this has for them and for society as a whole.

The Council is also concerned that the social security cash payments be made more adequate and, particularly, that the system take into account increases in prices and earnings levels that have occurred since the last time major revisions were made in the benefit provisions. One of the strengths of social insurance is its ability to adjust to changing economic conditions so that retired and disabled persons and survivors can share on a reasonable basis in the increasing productivity of our economy.

Other major recommendations of the Council relate to the way in which the social security program is financed, the maximum amount of annual earnings taxable and creditable toward benefits under the program (the contribution and benefit base) and the level of benefits and extensions of coverage.

The Council's recommendations, together with the considerations which prompted them, are presented in three parts. Part I presents the Council's findings with respect to the financing of the social security program, assuming no changes in the benefit and coverage provisions. Part II presents recommendations for an extension of the program to help meet the cost of hospital care and related services for the aged and the totally disabled. Part III of the report presents the Council's recommendations for improving the cash-benefit provisions, extending the coverage of the program and financing the recommended changes.

SUMMARY OF MAJOR FINDINGS AND RECOMMENDATIONS

I. FINANCING THE PRESENT PROGRAM

The Council has examined the financing of the present program apart from any changes which it is recommending and has found as follows:

1. *The Status of the Program and Allocation of Contribution Income.*—The social security program as a whole is soundly financed, its funds are properly invested, and on the basis of actuarial estimates that the Council has reviewed and found sound and appropriate, provision has been made to meet all of the costs of the program both in the short run and over the long-range future. The contribution income should be reallocated between the two trust funds, however, so that the disability insurance part of the program, like the old-age and survivors insurance part of the program and the program as a whole, will be in close actuarial balance.

2. *Adjustment in the Contribution Rate Schedule in the Short Range.*—The contribution rates now scheduled in the law should be adjusted to avoid the rapid increase in trust fund assets that will otherwise begin with the rate increases scheduled for 1966 and 1968.

3. *The Contribution Rates in the Long Range.*—There should continue to be included in the law a schedule of contribution rates which, according to the intermediate-cost estimates, will be sufficient to support the program over the long-range future. However, decisions about putting future rate increases into effect, once the rates actually being charged are high enough to cover the long-range cost of the program as shown by a reasonable minimum estimate, should be guided largely by estimates of program costs over a 15- or 20-year period.

4. *The Contribution and Benefit Base.*—The maximum amount of annual earnings that is taxable and creditable toward benefits needs to be substantially increased in order to maintain the wage-related character of the benefits, to restore a broader financial base for the program and to apportion the cost of the system among low-paid and higher-paid workers in the most desirable way.

5. *The Contribution Rate for the Self-Employed.*—Increases in the social security contribution rate for the self-employed beyond the present rate should be put into effect gradually, and only to the extent that the ultimate rate will be no more than 1 percent of earnings greater than the rate paid by employees.

6. *Maintaining the Integrity of the Trust Funds.*—To maintain the integrity of the trust funds, the reimbursement of the trust funds for the cost of paying social security benefits based on military service for which no contributions were paid should begin without further delay and the Board of Trustees should be given specific responsibility for reviewing those administrative charges against the trust funds which are based on estimates rather than on actual costs.

II. HOSPITAL INSURANCE FOR OLDER PEOPLE AND THE DISABLED

The Council proposes hospital insurance protection for those 65 or over and for disabled social security beneficiaries as follows:

1. *Inpatient Hospital Benefits.*—The proposed hospital insurance for people age 65 or over and the disabled should cover a number of days sufficient to meet the cost of inpatient hospital services for the full stay of almost all beneficiaries.

2. *Outpatient Hospital Diagnostic Services.*—Payment under the program should be made for the costs of outpatient hospital diagnostic services furnished beneficiaries.

3. *Deductibles.*—Hospitalized beneficiaries should pay a deductible equal to the cost of one-half day of care—\$20 at the program's beginning. In the case of beneficiaries who are provided outpatient diagnostic services, this deductible amount should be applied for each 30-day period during which diagnostic services are provided.

4. *Services in Extended-Care Facilities.*—The cost of posthospitalization extended-care services in facilities which provide high-quality rehabilitative and convalescent services should be covered so as to pay for a minimum number of days after hospitalization in all cases, with additional days of extended-care services being paid for if the patient has not used all of his inpatient hospital coverage.

5. *Organized Home Nursing Services.*—Insurance coverage should be provided for organized home nursing services.

6. *Payments on the Basis of Reasonable Cost.*—The extent of hospital insurance and related protection should be specified in terms of the services covered rather than in terms of fixed dollars, and covered services should be paid for on the basis of the full reasonable cost of the services.

7. *Hospital Staff Review of Utilization.*—Hospitals should be required, as a condition of participation, to establish professional staff committees to review the services utilized.

8. *Administration.*—The proposed hospital insurance provisions should be administered by the same Federal agencies which administer the social security program but in carrying out this responsibility the Federal Government should use private and State agencies to the extent that these agencies can contribute to efficient and effective operation.

9. *The Basis of Eligibility for Benefits.*—Hospital insurance benefits should be provided for aged and disabled beneficiaries of the social security program, and special provision should be made for the next few years for those who have not met the requirements of eligibility under the program.

10. *Financing.*—The proposed hospital insurance program should be financed by a special earmarked contribution of 0.4 percent of covered earnings from employees and from employers, and 0.5 percent from the self-employed, with an 0.15 percent contribution from Federal general revenues to cover the cost of benefits for those already retired or disabled.

III. IMPROVEMENTS IN THE CASH-BENEFIT PROVISIONS

The Council has examined all aspects of the present program of cash benefits and is recommending changes as follows:

SOCIAL SECURITY BENEFIT AMOUNTS

1. *The Period for Computing Benefits for Men.*—The period for computing benefits (and insured status) for men should be based, as is now the case for women, on the period up to the year of attainment of age 62, instead of age 65 as under present law, with the result that 3 additional years of low earnings would be dropped from the computation of retirement benefits for men.

2. *A General Increase in Benefits.*—A general increase in benefit amounts, accomplished by a change in the way the benefit formula is constructed, should be provided to take into account increases in wages and prices since the last general benefit increase in 1958, and the maximum on monthly family benefits should be related to earnings throughout the benefit range.

3. *The Maximum Lump-Sum Death Payment.*—The maximum lump-sum death payment should not be set in terms of an absolute dollar limit but rather should be the same as the highest family maximum monthly benefit.

DEPENDENTS' AND SURVIVORS' BENEFITS

4. *Children Over Age 18 Attending School.*—Benefits should be payable to a child until he reaches age 22, provided the child is attending school between ages 18 and 22.

5. *Disabled Widows.*—The disabled widow of an insured worker, if she became disabled before her husband's death or before her youngest child became 18, or within a limited period after either of these events, should be entitled to widow's benefits regardless of her age.

6. *Definition of Child.*—A child should be paid benefits based on his father's earnings without regard to whether he has the status of a child under State inheritance laws if the father was supporting the child or had a legal obligation to do so.

DISABILITY BENEFITS

7. *Young Disabled Workers.*—Young workers who become disabled should have their eligibility for benefits determined on the basis of a test of substantial and recent employment that is appropriate for such workers.

8. *Rehabilitation of Disability Beneficiaries.*—The social security program should pay the costs of rehabilitation for disability beneficiaries likely to be returned to gainful work through such help, with the rehabilitation services being provided through State vocational rehabilitation agencies.

ELIGIBILITY FOR BENEFITS

9. *Insured Status.*—The Council recommends retention of a requirement of covered work as a test of eligibility for benefits, and has no major changes to recommend in the present provisions.

10. *Retirement Test.*—The provision in the law that prevents the payment of benefits to a person with substantial earnings from current work—the retirement test—is essential in a program designed to replace lost work income and should be retained.

EXTENDING THE COVERAGE OF THE PROGRAM

11. *Doctors of Medicine.*—Self-employed doctors of medicine should be covered on the same basis as other self-employed people now covered, and interns should be covered on the same basis as other employees working for the same employer.

12. *Tips.*—Social security contributions should be paid on tips an employee receives from a customer of his employer, and tips should be counted toward benefits.

13. *Federal Employees.*—Social security credit should be provided for the Federal employment of workers whose Federal service was covered under the civil service retirement system but who are not protected under that system at the time they retire, become disabled, or die.

14. *State and Local Government Employees.*—The coverage of additional State and local government employees should be facilitated by making available to all States the option of covering only those present members of State and local government retirement system groups who wish to be covered, with coverage of all

new members of the group being compulsory. Also, policemen and firemen in all States should be provided the same opportunity for coverage as other State and local government employees.

The tax rates needed to finance the changes recommended by the Council

[The contribution rates under present law are applicable to annual earnings up to \$4,800; the proposed contribution rates would apply to annual earnings of \$4,900 in 1965, \$6,000 in 1966 and 1967, and \$7,200 in 1968 and thereafter]

Period	Employee and employer, each			Self-employed		
	OASDI		Hospital insurance ¹	OASDI		Hospital insurance ¹
	Present law	Proposed		Present law	Proposed	
1965	3.625	3.625		5.4	5.4	
1966-67	4.125	4.3	0.4	6.2	5.8	0.5
1968-70	4.625	4.3	.4	6.9	5.8	.5
1971-75	4.625	4.7	.4	6.9	6.0	.5
1976 and after	4.625	5.3	.4	6.9	6.3	.5

¹ The financing of the proposed hospital insurance program would also include a level contribution of 0.15 percent of covered payroll from Federal general revenues for the next 50 years (not shown in the table).

PART I. FINANCING THE PRESENT PROGRAM

In this part of the report the Council presents the results of its study of the financial status of the existing social security program and of the principles underlying the legislative provisions for social security financing. The financial implications of the Council's recommendations for program improvements as set forth in parts II and III of the report are presented in conjunction with those recommendations.

The financing provisions of present law are as follows: Employees pay contributions on their annual earnings up to a maximum of \$4,800. Each employer pays at the same rate as the employee on the first \$4,800 paid to each of his employees in the year. The self-employed pay at a rate approximately equal to 1½ times the rate paid by employees. Contribution rates are scheduled to increase from an employer and employee rate of 3¼ percent each in 1965 to 4½ percent each in 1966 and to an ultimate rate of 4¾ percent each in 1968. The contribution rates now scheduled are intended to provide enough income to meet all of the costs of the system, including administration, into the indefinite future.

Funds not needed for immediate benefit payments are invested in obligations of the United States Government and the interest earnings on these obligations are available to help pay the cost of the system. The scheduled contribution rates include an allocation to the separate disability insurance trust fund of one-half of 1 percent from the combined employer and employee contribution (three-eighths of 1 percent for the self-employed).

I. THE STATUS OF THE PROGRAM AND ALLOCATION OF CONTRIBUTION INCOME

The social security program as a whole is soundly financed, its funds are properly invested, and on the basis of actuarial estimates that the Council has reviewed and found sound and appropriate, provision has been made to meet all of the costs of the program both in the short run and over the long-range future. The contribution income should be reallocated between the two trust funds, however, so that the disability insurance part of the program, like the old-age and survivors insurance part of the program and the program as a whole, will be in close actuarial balance.

As indicated in the latest Trustees' Report, the social security program as a whole is in actuarial balance both over the short run and for the long-range future. The review of the actuarial estimates conducted by the Council supported this conclusion of the Trustees. In the Council's opinion, based on actuarial estimates that the Council has reviewed and found sound and appropriate, the contribution rates in present law will supply income which, together with interest earnings on the funds, will be sufficient to meet all benefit costs and administrative expenses as they fall due.

While the old-age and survivors insurance part of the program and the program as a whole are in close actuarial balance, the disability insurance part of the program (which involves only a small proportion of the total cost of the system), when looked at separately, is underfinanced. It was recognized at the time of the last major disability amendments in 1960 that the income to the disability fund was likely to be about 0.06 percent of covered payroll short of what was needed for the long run. Experience since that time has indicated that disability benefit termination rates due to death and recovery of the beneficiary are lower than had been assumed in the earlier estimates, so that the expected deficit is now about 0.14 percent of covered payroll. To correct this situation, the Council endorses the recommendation of the Board of Trustees that there be a small reallocation of contribution income—the Council would favor 0.15 percent of covered payroll for present law—from the old-age and survivors insurance trust fund to the disability insurance trust fund.¹ This could be done without any increase in the over-all contribution rates now scheduled for the program and would put the disability insurance part of the program in close actuarial balance, while also leaving the old-age and survivors insurance part and the program as a whole in close balance.

In arriving at the conclusion that the system as a whole is in actuarial balance, the Council examined not only the results of the estimates but also the techniques used and the assumptions on which the estimates are based. It found that the techniques used in preparing the estimates of the cost of the program are in accordance with sound actuarial practice and that the assumptions on which these estimates are based are appropriate. The estimates take full and proper account of the various economic and demographic factors affecting the future cost of the program.² The Council favors the continuance of present practice under which estimating techniques and the assumptions underlying the estimates and the contribution schedule are re-examined and adjusted in the light of developing experience.

The Council believes that it is proper for a national system of compulsory social insurance to use what is known as an "open-group" technique in preparing actuarial cost estimates—that is, to take into account not only present assets, future benefits for present beneficiaries, and future contributions and benefits with respect to workers now covered, but also the contributions and benefits to be paid with respect to workers to be covered in the future as well. The Council is in agreement with the previous groups that have studied the financing of the program that it is unnecessary and would be unwise to keep on hand a huge accumulation of funds sufficient, without regard to income from new entrants, to pay all future benefits to past and present contributors. A compulsory social insurance program is correctly considered soundly financed if, on the basis of actuarial estimates, current assets plus future income are expected to be sufficient to cover all the obligations of the program; the present system meets this test. The claim sometimes made that the system is financially unsound, with an unfunded liability of some \$300 billion, grows out of a false analogy with private insurance, which because of its voluntary character cannot count on income from new entrants to meet a part of the future obligations for the present covered group.

It is important to note that the long-range cost estimates prepared for the program are based on the assumption that earnings will remain at a given level (at the 1963 level under the estimates shown in this report). If average earnings continue to rise in the future, as there is reason to expect they will, then, assuming no change in other cost factors, the income of the program relative to outgo will be considerably higher than the estimates show.³ The Council believes that making the estimates on a level-wage assumption allows for a desirable margin of safety and recommends that the practice be continued in making the long-range estimates. If the assumptions which underlie the intermediate or low-cost estimates are borne out by experience, then the use of level wages allows for

¹ Under the Council's recommendations discussed in Part III, the reallocation should be 0.25 percent of covered payroll rather than 0.15 percent.

² Since over the long-range future the cost of the program will be affected by many factors that do not lend themselves to precise measurement, assumptions regarding them may differ widely and yet be reasonable. For this reason, high-cost and low-cost assumptions are made for the various factors affecting the long-range cost of the program. Intermediate-cost estimates are then derived by averaging the high-cost estimates and the low-cost estimates. The Council believes that these intermediate-cost estimates provide a reasonable basis for gauging the long-range cost implications of present benefit provisions and proposals for changes.

³ The reason for this effect of rising earnings is that benefits based on low earnings are a higher percentage of the worker's average monthly wage than are benefits based on higher earnings, and therefore, as earnings go up, benefits as a percentage of earnings go down. Contributions, on the other hand, are the same percentage of covered earnings at all levels. As earnings go up, then, the benefit outgo as a percentage of covered earnings decreases while the contribution income as a percentage of covered earnings stays the same.

benefit increases if wages rise without any increase in the contribution rates. If experience comes close to the high-cost assumptions, then the use of the level-wage assumption will result, if wages rise, in an offset to the cost consequences of the unfavorable experience and still allow for some upward adjustment in benefits without any increase in the contribution rates. —

The Council suggests only one significant change in the assumptions underlying the long-range estimates. In the past an attempt has been made to present cost estimates into perpetuity. Specifically, it has been assumed for purposes of the estimates that trends for the factors affecting the cost of the program will level off at some point in the distant future (about 85 to 90 years) and continue at that level indefinitely. The Council believes that it serves no useful purpose to present estimates as if they had validity in perpetuity. A period of 75 years would span the lifetime of virtually all covered persons living on the valuation date and is as long a period as can be expected to have a realistic basis for estimating purposes. When costs are reassessed at frequent intervals, as has always been the practice, 75-year projections allow sufficient time to adjust to new and changing experience as it emerges. The long-range cost estimates shown in this report, therefore, are developed for a period of 75 years and it is our recommendation that long-range estimates in the future also be made on this assumption. The effect of this changed procedure is to make the estimated level-cost of the present program about 3 percent lower (about 0.25 percent of payroll) than when using the earlier procedure. At the same time the Council believes that the financing should be such that the actuarial status of the program will be reasonably close to an exact balance according to the intermediate-cost estimates.⁴

The Council has also examined the practices followed with respect to investment of the funds of the program. From the inception of the program in 1937, the investment of trust fund assets has been restricted by law to interest-bearing obligations of the United States or obligations guaranteed as to principal and interest by the United States. The investments can be either in special obligations issued exclusively for purchase by the trust funds or in publicly available obligations of the Federal Government. Under the present provisions of the Social Security Act relating to the investments of the trust funds, the special obligations issued exclusively to the trust funds bear interest rates equal to the average market yield at the end of the preceding month on all interest-bearing marketable obligations of the United States not due or callable for 4 or more years after that date. This market-yield formula, based on the recommendations of the Advisory Council on Social Security Financing appointed in 1957, has served as a model for determining interest rates on special obligations issued to certain other Federal trust funds. This Council believes that the present procedures for investing the trust funds and for setting the interest rates on the special obligations are satisfactory.

2. ADJUSTMENT IN THE CONTRIBUTION RATE SCHEDULE IN THE SHORT RANGE

The contribution rates now scheduled in the law should be adjusted to avoid the rapid increase in trust fund assets that will otherwise begin with the rate increases scheduled for 1966 and 1968.

The 1956 legislation establishing the social security advisory councils scheduled them so that each would make its report 1 year before the date when an increase in the social security contribution rates was due to go into effect, and one of the primary duties of the councils, as specified in the law, is to make recommendations with respect to the social security contribution schedule. Thus the Council recognizes a special obligation, without regard to other changes it is recommending, to report its findings and make recommendations regarding the social security contribution rates designed to support the existing program.

The benefit outgo of the program will increase for many years, mainly because of the increasing number of people eligible for benefits at age 62 or over. This increasing cost is to be met under the present law by raising the rates to 4½ percent each for employees and employers and to 6.2 percent for the self-employed in 1966, and finally to 4⅝ percent each for employees and employers and 6.9 percent for the self-employed in 1968. The question to which the Council is here addressing itself is whether changes should be made in these scheduled rate increases.

On the basis of the actuarial cost estimates the Council has examined, it is clear that some increase in income to the program over what the 3⅝ percent tax

⁴ Traditionally the social security program has been considered in actuarial balance when, on the basis of the long-range intermediate-cost estimates projected into perpetuity, the actuarial insufficiency was not greater than 0.30 percent of payroll for the program as a whole. The Council believes that a closer balance would be desirable when the long-range cost estimates are projected over a 75-year period.

rate now in effect would produce will be needed in 1966. The Council finds, however, that the increase to 4½ percent each for employers and employees now scheduled for 1966 and 1967 is higher than it believes is desirable for several years.

The Council is recommending an increase in the contribution and benefit base in order to maintain the wage-related character of the benefits, to restore a broader financial base for the program, and to apportion the cost of the program appropriately between high-paid and low-paid workers. If the increase in the base is adopted in accordance with the Council's recommendation, the increase needed in 1966 in the income of the program will be provided thereby. If the base is not increased, and if all other provisions remain unchanged, the Council would propose the contribution rate be increased in 1966 to 3.9 percent. This rate would produce a slight excess of income over outgo for about 2 years. In the Council's opinion it is highly desirable that the income to the funds exceed outgo year by year. As has been evidenced in several recent years, if this is not the situation, there is danger of public misunderstanding of the financial condition of the program. On the other hand, as nearly as can now be determined, it would seem to be desirable from the standpoint of the general economy to avoid the deflationary effect of large trust fund accumulations.

In the absence of any other changes in the law the Council would also propose revisions in the rates scheduled for 1968 and later years. The imposition of the 4½ percent rate as scheduled in 1968 would build very large trust fund accumulations—as much as \$4 billion a year—and would also involve the possibility of imposing rates higher than will ever be needed to pay for the benefits provided under present law. The rate of 4½ percent in 1968 is designed to meet long-range costs falling about halfway between the high- and the low-cost estimates. If the actual experience is close to the low-cost estimates, for example, a contribution rate of 4½ percent in 1968, rather than 4½ percent, would cover the cost of the present program for 75 years.

This Council agrees with the last Advisory Council in the view that once the social security contribution rates actually in effect are high enough to cover the long-range cost of the program as shown by a reasonable minimum estimate, then decisions on whether scheduled rate increases are allowed to go into effect should be guided largely by conditions expected in the 15- or 20-year period immediately ahead. The Council recommends that if the present program continues unchanged in other respects the proposed 3.9 percent rate for 1966 be continued through 1968 and the rate scheduled for 1969–1971 be 4.1 percent of payroll. This figure is close to the 75-year level cost of the program under the low-cost estimates. The recommendations for rates to be included in the law for years after 1971—but to be allowed to go into effect only if developing conditions indicate that they will be necessary—are given on page 70.

The Council believes that reducing the scheduled rates as suggested for the 6 years after 1965 would not threaten the financial soundness of the program. Since continuing income from social security contributions is assured, the only fund balances required are those needed to meet temporary excesses of outgo over income due to relatively high benefit costs or low social security tax revenue in a particular period. In the opinion of the Council, fund balances high enough to maintain the solvency of the program in the face of recession conditions as severe as, say, those referred to in the annual report of the Board of Trustees—that is, conditions that would prevail if there were a drop of 5 million in the number of people with covered earnings in a year—would be adequate to provide protection against any contingency that might reasonably be expected, and the trust fund balances resulting from the Council's recommended rate schedule would be sufficient to do this.⁵

Holding the trust funds to reasonable contingency levels, instead of allowing them to increase as they would under the present tax schedule, will of course mean a loss of interest income to the program. However, despite the very substantial funds that would be built up under the present schedule, the interest earned on these funds is expected to supply only about 10 to 15 percent of the income of the program over the long-range future. Thus the role of the trust funds as interest-earning reserves is not very great even under the present schedule; the funds are even now to be thought of largely as a reserve to meet unexpected contingencies rather than as funds for the purpose of earning interest. Moreover, if the system is improved as earnings levels rise in the future, as seems likely to be the case, interest earnings on a fund of any given size will meet a decreasing

⁵ The Trustees follow a practice of including in their annual report an illustration of the effect that a sharp reduction in the level of economic activity and an increase in the rate of unemployment would have on the operations of the program. In the opinion of the Council this is a desirable practice and should be continued.

proportion of benefit costs. It may therefore prove to be unwise to count on interest earnings meeting even as large a part of benefit costs in the distant future as is now contemplated.

The Council does not consider the use of interest in the financing of the program to be a major issue. A reasonable contingency fund will result in interest earnings which will supply 4 to 5 percent of benefit costs. Even under the present contribution schedule interest earnings may not exceed 10 percent of costs. The Council believes that, on balance, any advantage of imposing rates that will build up large interest-earning trust funds is outweighed by the disadvantages.

3. THE CONTRIBUTION RATES IN THE LONG RANGE

There should continue to be included in the law a schedule of contribution rates which, according to the intermediate-cost estimates, will be sufficient to support the program over the long-range future. However, decisions about putting future rate increases into effect, once the rates actually being charged are high enough to cover the long-range cost of the program as shown by a reasonable minimum estimate, should be guided largely by estimates of program costs over a 15- or 20-year period.

Like the last Advisory Council, the present Council endorses the practice of including in the law a contribution schedule that, according to the intermediate-cost estimates, places the system in actuarial balance over the long-range future. As that Council pointed out, this procedure is needed to make people conscious of the long-range costs of the program and the costs of proposals to change the program. Accordingly, this Council is recommending that for the present program, if the contribution rates it recommends for 1966 and 1969 are put into effect (bringing the rates about to the level needed for the next 75 years under the low-cost estimates), further contribution rate increases nevertheless should be scheduled in the law for 1972 and 1975. The 1972 rate should reflect the estimated cost for the next 3 years on the basis of the long-range intermediate-cost estimate, while the 1975 rate should represent the level-cost for the succeeding 65 years. The employee (and employer) rate for 1972-74 should be 4.3 percent. A rate of 4.7 percent effective in 1975 would be sufficient to finance the present program under the intermediate-cost estimate throughout the period covered by the estimate.

While the Council believes that the rates for 1972 and 1975 should be scheduled in the law in order to assure public appreciation of the approximate long-range cost of the program, decisions on whether these rates should be put into effect as scheduled, since they are higher than would be needed if the low-cost estimates are borne out by experience, should be made in the light of circumstances prevailing just before the proposed effective dates. These decisions should be made largely in the light of conditions that are expected to exist over the 15 or 20 years following the proposed effective dates.

If there are no other changes in the program, and if the contribution and benefit base is not increased, the Council would recommend that the 4.125 percent rate scheduled for employees and employers in 1966 be reduced to 3.9 percent, that the rate be held at this level through 1968, and that the rate for 1969 be set at 4.1 percent. Rates of 4.3 percent in 1972 and 4.7 percent in 1975 should be scheduled in the law, subject to future review. If the Council's recommendations for improvements in the program are adopted, the rates would of course need to be higher than those shown here; the cost of the changes and the recommended rates for the cash-benefit program as it would be improved are shown on page 102.

The financing of hospital insurance is discussed on pages 82-85.

4. THE CONTRIBUTION AND BENEFIT BASE

The maximum amount of annual earnings that is taxable and creditable toward benefits needs to be substantially increased in order to maintain the wage-related character of the benefits, to restore a broader financial base for the program and to apportion the cost of the system among low-paid and higher-paid workers in the most desirable way.

The Council recommends that the maximum amount of annual earnings that is taxable and creditable toward benefits—the contribution and benefit base—be increased to at least \$6,000 effective in 1966 and \$7,200 effective in 1968. These increases are needed in order to maintain the wage-related character of the benefits, to restore a broader financial base for the program, thus keeping the contribution rates lower than they would otherwise have to be, and to apportion the cost of the system appropriately.

As is discussed in Part III, failure to keep the contribution and benefit base up to date has serious effects on the benefit protection provided as more and more workers have earnings above the base and their benefits are related to a smaller and smaller part of their earnings. In addition, unless the contribution and benefit base is increased as earnings rise, the foundation of the financing of the program—the proportion of the Nation's payrolls which is subject to social security contributions—is weakened.

Moreover, if benefits were raised without increasing the contribution and benefit base, the increases in the contribution rates would have to be higher than they would have to be if the base were raised, and lower-paid workers as well as those earning at or above the maximum would have to pay these higher rates. It is much more desirable to meet the cost of increased protection for workers at average or higher earnings levels by increasing the amount of earnings on which those workers contribute than by increasing the contribution rates that all workers pay.⁶

The contribution and benefit base is now substantially out of date because of large advances in the general wage level. When the program was enacted in 1935, the \$3,000 base provided would have covered 95 percent of total earnings in covered work in that year, and would have covered the full earnings of 98 percent of all workers and of 97 percent of regularly employed men.⁷ When the base was raised to \$3,600 in 1950, the \$3,600 base would have covered 86 percent of earnings in covered work and all of the earnings of 81 percent of all workers and of 62 percent of regularly employed men. In 1965, with the \$4,800 base, only about 72 percent of earnings in covered employment will be taxed to support the program and only 66 percent of all workers and 36 percent of regularly employed men will have all their earnings covered.

The concept embodied in the original \$3,000 base was that practically all of the Nation's covered payrolls should be subject to contributions for the support of the program and that all but the most highly paid workers should have all their earnings counted toward benefits. The Council does not think it would be practicable to attempt at this time to restore all of the ground that has been lost over the years. A base of \$14,500 would be needed now to cover 95 percent of total earnings in covered work, as was contemplated in 1935. Nor does the Council believe it necessary that the original situation with respect to the proportion of total earnings covered under the program be fully restored in order to carry out the general principles of the original Act.

The Council believes that a return to the relationship that existed in 1950, the first year the Congress increased the contribution and benefit base, is a practical goal. The council recognizes, however, that it may not be practical to move to this level in one step, and is recommending, therefore, that the base be increased at least to \$6,000 for 1966 and 1967 and to \$7,200 in 1968. A contribution and benefit base of \$7,200, if effective in 1968, would, it is estimated, tax about 80 percent of total earnings in covered work and would result in 82 percent of all workers, and 63 percent of regularly employed men, having all their earnings counted toward benefits.⁸ The result would be comparable to the 1950 situation in respect to the last two measures and somewhat short in respect to the first measure.

The members of the Council are agreed on the changes here recommended as the minimum desirable. Some members, however, think that the proposed amounts for the contribution and benefit base are not high enough and would recommend that they be substantially greater, rising in the second step to nine or ten thousand dollars. This group believes that it is important to go beyond restoring the 1950 situation and move toward the situation contemplated under the original Social Security Act.

⁶ If the base were restored to a figure comparable to the \$3,000 figure provided in the 1935 legislation, the ultimate contribution rate for employee and employer under the present program could be reduced for each by about 0.5 percent. If it were raised to a figure comparable to \$3,600 at the time that figure was written into the law in 1950, the ultimate rate for the present program could be reduced by about 0.3 percent each.

⁷ Measures of the effectiveness of the contribution and benefit base that have been used from time to time include the proportion of earnings taxed for the support of the program, the proportion of all workers who have all of their earnings credited toward benefits, and the proportion of regularly employed men (generally the primary earners) who have all of their earnings credited toward benefits. The first is probably most important for financing and the third for an evaluation of the adequacy of the benefit structure.

⁸ If earnings levels continue to increase at about the same rate as they increased over the last 5 years, average earnings in covered work will increase about 4 percent per year during the period January 1964-January 1968.

5. THE CONTRIBUTION RATE FOR THE SELF-EMPLOYED

Increases in the social security contribution rate for the self-employed beyond the present rate should be put into effect gradually, and only to the extent that the ultimate rate will be no more than 1 percent of earnings greater than the rate paid by employees.

Since 1951, when self-employed people were first brought into the social security program, they have paid social security contributions at a rate $1\frac{1}{2}$ times the rate paid by employees. The policy of imposing the contribution at this $1\frac{1}{2}$ -times rate, balances two opposing considerations. On the one hand, to the extent that the self-employed person does not contribute at rates as high as the combined employee-employer rate, there is a financial disadvantage to the program in covering him, as compared to covering an employee. On the other hand, looked at from the standpoint of an individual contributing toward his own protection, some self-employed people will be "overcharged" when paying over a lifetime at the ultimate rate now scheduled.

Although the policy of setting the self-employed rate at $1\frac{1}{2}$ times the employee rate seemed a reasonable compromise at the time it was adopted, the Council believes that, as the rates have gone up, the substantial difference between the employee rate and the self-employed rate has become difficult to justify. The contributions paid by self-employed people above the rates paid by employees are, like employers' contributions to the program, used in large part to help provide protection for low-paid workers, workers with large families and workers who were already on in years when their jobs were first covered.⁹ The Council believes that it is reasonable to use the contributions of an employer for general purposes, rather than for the benefit of the particular employees on whose earnings the contributions are based, as long as the employee can in general be said to get his own money's worth. On the other hand, the Council does not believe that self-employed workers should as a rule be charged rates for their own coverage beyond the rates needed to pay for the protection they are provided by the program in order to help meet the cost of the protection provided to others.

The Council recommends, therefore, that, except for the financing of new types of benefits such as hospital insurance, increases in the social security tax rate for the self-employed beyond the rate now being charged be put into effect only to the extent that the self-employed will pay no more than 1 percent of covered earnings above the rate paid by employees at the time the ultimate rate goes into effect.¹⁰ With self-employed contributors paying, ultimately, 1 percent of earnings more than employees, their contribution rate would reflect the fact that to a degree they are in the same position as an employer, that is, that they are their own employers. At the same time, they would not be overcharged when paying for a full working lifetime at the ultimate contribution rate.¹¹

6. MAINTAINING THE INTEGRITY OF THE TRUST FUNDS

To maintain the integrity of the trust funds, the reimbursement of the trust funds for the cost of paying social security benefits based on military service for which no contributions were paid should begin without further delay and the Board of Trustees should be given specific responsibility for reviewing those administrative charges against the trust funds which are based on estimates rather than on actual costs

The last Advisory Council called the management of the social security trust funds "the greatest financial trusteeship in history." This Council agrees, and it has reviewed the management of the funds to be sure that their integrity is maintained. As a result of its study, the Council has concluded that, in general, the trust funds are managed with due regard for their nature as funds held in trust

⁹ Actually, a part of the employers' contributions (about 15 to 20 percent)—and of that part of the self-employed person's contribution that exceeds the employee contribution—is used to meet the cost of benefits for the long-term better-paid worker, since the contributions of this group do not quite cover the cost of their own benefits.

¹⁰ In Part II the Council also recommends that the contribution rate for the self-employed under the hospital insurance proposal be only a little above that for employees—0.5 percent of earnings for the self-employed and 0.4 percent for employees.

¹¹ The contribution rate paid by the self-employed person in excess of that paid by the employee would roughly cover the difference between the value of the contributions paid over a lifetime at the ultimate rate by employees earning at the maximum covered amount and the value of the old-age, survivors, and disability insurance protection received by a person covered by the system over a whole working lifetime and earning at the maximum covered amount.